Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Oropeza | Analyst: Marion Mann DeJong | Bill Number: AB 263

Related Bills: See Prior Analysis | Telephone: 845-6979 | Amended Date: 06/02/2003

Attorney: Patrick Kusiak | Sponsor: ________

SUBJECT: Dividends Received Deduction/Ceridian Issue/FTB Report to Legislature Regarding Tax Collected Pursuant to Dividend-Received Deduction

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ________________________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ________________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________________.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 4, 2003, STILL APPLIES.

____ OTHER - See comments below.

SUMMARY

This bill would specify how to apply the tax statute allowing a deduction for dividends received from an insurance company after the statute was found unconstitutional in the *Ceridian* decision.

SUMMARY OF AMENDMENTS

The June 2, 2003, amendments changed the deductible percentage of dividends received from an insurance company subsidiary for prospective years from 95% to 80%.

The May 20, 2003, amendments made the following changes:

- Specified the percentage of dividends received from an insurance company subsidiary the taxpayer may deduct.
- Modified the election provision.
- Added a provision to repeal the deduction for prospective years if less than $15 million is collected for the open years.
- Added a requirement that the Franchise Tax Board (FTB) report to the Legislature regarding the amount collected for open years.

These amendments resolved the department's implementation and technical considerations discussed in the prior analysis of the bill. New "This Bill," "Implementation Considerations," "Technical Considerations," "Economic Impact," and "Legal Considerations" discussions are provided below. Except for these discussions, the remainder of the department's analysis of the bill as introduced February 4, 2003, still applies. This analysis replaces the department's analysis of the bill as amended March 25, 2003. The Board position remains pending.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP	Brian Putler	6/27/03
____ SA	____ O	____ NAR		
____ N	____ OUA	__x__ PENDING		

Summary of Suggested Amendments

Amendments are needed to resolve the department's implementation concerns regarding the $15 million threshold and the reporting requirement. Department staff is available to assist the author with the amendments. In addition, amendments are provided to resolve the department's technical considerations. See "Implementation Considerations" and "Technical Considerations" below.

ANALYSIS

THIS BILL

This bill would repeal and re-enact Revenue and Taxation Code (RTC) Section 24410 to allow taxpayers that own 80% or more of a subsidiary engaged in an insurance business to deduct 80% of dividends received from that subsidiary. The deduction would be allowed regardless of whether the insurance company is engaged in business in California. The deduction would apply to taxable years beginning on or after January 1, 2003.

For taxable years ending on or after December 1, 1997, and beginning before January 1, 2003, a taxpayer could elect to deduct 90% of dividends received from an insurance company subsidiary.

The taxpayer must make the election on at least one return for the election period (1997 to 2002). The election must be made within 180 days of the effective date of the bill. By making the election, the taxpayer would agree to all of the following:

- To be subject to the dividends received deduction percentage for all taxable years in the election period.
- To report and remit any amounts due pursuant to the election for all open taxable years in the election period. This remittance must occur within 180 days of the effective date of the bill or by the due date of the return for taxable years where the return is due more than 180 days after the effective date of the bill.
- That the dividends are business income and are deductible only in the percentage allowed by this bill.

The election would be irrevocable once made and would apply only to taxable years during the election period for which the statute of limitations is open. Where the statute of limitations has closed for any particular year during that period, the election would apply if the final determination of tax has not been made for the taxable year because of a dispute related to the dividends received deduction or Section 24425 expenses related to that dividends received deduction.

For purposes of determining taxable income for the taxable years during the election period, RTC Section 24425 would not apply to any expense related to Section 24410 dividends. Thus, taxpayers would not be required to reduce any expenses related to the Section 24410 dividends.

This bill would repeal the part of Section 24410 that allows an 80% deduction for taxable years beginning on or after January 1, 2003, if the amount of tax collected pursuant to the dividends received deduction for the election period is less than $15 million. The $15 million in tax must be collected by the later of 180 days after the effective date of the bill or by the original due date of the return for taxable year 2002.

FTB must report to the Legislature regarding the amount of tax collected pursuant to the election. The report must be made by the later of 30 days after the close of the election period or March 15, 2004.

The bill also would make the following legislative declarations:

- The amendments to Section 24410 serve a public purpose and are necessary to provide for the equitable tax treatment of insurance company dividends in light of: (1) the *Ceridian* decision held that Section 24410 violates the Commerce Clause of the United States Constitution, (2) that insurance company dividends do not qualify for a deduction under Section 24402 and are not eligible for elimination from income as provided for in Section 25106, and (3) that a number of corporations filed returns claiming deductions for all or part of the dividends they received from insurance subsidiaries because of uncertainty following the *Ceridian* decision.

- The amendments to Section 24410 serve a public purpose and are in furtherance of the public interest in avoiding the unanticipated denial of a deduction for insurance company dividends. Denial of this deduction would have a detrimental effect upon the economy of California.

- The retroactive application of the amendments to Section 24410 serve a public purpose and promote sound tax policy by affording equitable tax relief to taxpayers that relied upon Section 24410 in expectation that they would be entitled to a deduction with respect to a portion of the dividends received from insurance companies.

- Section 24425 denies a deduction with respect to any amount otherwise allowable as a deduction that is allocable to a class of income that is not included in the measure of tax. The department contends that where a taxpayer claims a dividends received deduction for insurance company dividends, deductions for expenses associated with income not included in the measure of tax are disallowed under Section 24425. In contrast, the industry contends that Section 24425 does not apply under any circumstance.

- The amendment to Section 24410 that declares Section 24425 to be inapplicable to the dividends received deduction for tax years ending on or after December 1, 1997, and before January 1, 2003, represents an integral part of the legislative resolution of the uncertainty created by the *Ceridian* decision, and accordingly furthers the same valid public purposes identified above.

- No inferences should be made with respect to the application of Section 24425 to the deductions allocable to dividends received deduction for taxable years ending before December 1, 1997, or beginning on or after January 1, 2003.

- The tax treatment of insurance company dividends as provided by this bill is unrelated to and distinguishable from the tax treatment of the deduction of general corporate dividends under Section 24402 and the application of Section 24425 to deductions allocable to those dividends.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill should not significantly impact the department's programs and operations. The $15 million threshold and the reporting requirement may result in difficulty both in identifying returns making the election and in determining whether the $15 million threshold was met within 30 days. The election procedure may need to be modified to help the department identify the taxpayers making the election. Department staff will work with the author on this issue as the bill moves through the Senate.

TECHNICAL CONSIDERATIONS

Amendment 1 would correct an incorrect reference.

Section 4 of the bill specifies that $15 million tax must be "collected." This implies that voluntary payments are not included in the $15 million threshold. Amendments 2 and 3 would change this term to "remitted or collected."

The repeal language in Section 4 of the bill does not specify that the $15 million tax is related to the election. Amendment 4 would make this change.

ECONOMIC IMPACT

Revenue Estimate

The revenue implications of this bill depend on whether current law is no deduction or a 100% deduction for dividends received from an insurance company subsidiary. If it were assumed that no deduction is allowed (current departmental practice), based on data and assumptions discussed below, this bill would result in the following cash flow revenue impact.

Projected Timing of the Revenue Impact of AB 263 As Amended 06/02/03 [$ In Millions]		
2003-04	2004-05	2005-06
$15	-$175	-$95

Due to uncertainty regarding the final outcome of what constitutes current law, the bill would result in potential additional tax collected from electing taxpayers for specified open years. For taxpayers that would otherwise claim a 100% deduction but elect the 90% option due to the uncertainty issue, it is expected that this portion of the bill would result in net additional tax collected from such taxpayers for specified open years of $15 million in 2003-04, the amount necessary to retain the proposed 80% DRD for prospective years.

Revenue Discussion

As indicated above, the revenue implications of this bill depend on whether current law is no deduction or a 100% deduction for dividends received from an insurance company subsidiary. This analysis assumes the former applies.

Based on audit staff review of available tax returns, the potential reduction in tax liability for all open years (1997-2002) without Section 24425 is $190 million (plus interest) and $28 million with Section 24425 on a prospective tax year basis. The estimates in the above table attempt to reflect the "timing" of these impacts on a fiscal year basis and also the $15 million payment requirement on the part of taxpayers. These projections required making several "best judgment" assumptions about the timing of how and when cases would otherwise be finalized.

Audit staff conducted a survey that identified cases with Ceridian related issues in the current audit inventory. Case-by-case, auditors calculated the tax implications for either denying the claimed deduction or allowing a 100% deduction. As the bill proposes a somewhat reduced deduction, tax amounts were adjusted to reflect proposed deductions of 90% for open years and 80% for ongoing years. Tax implications were summed for each taxable year included in the audit survey. If survey data were limited or missing for certain open years, results were extrapolated from known years. With respect to the number of open years, it is assumed that taxpayers previously allowed a deduction would have six-open tax years, and taxpayers not previously allowed a deduction, four-open tax years.

LEGAL IMPACT

Currently, the industry and the department disagree regarding the application of RTC Section 24425 to insurance company dividends. The department contends that where a taxpayer claims a dividends received deduction for insurance company dividends, expenses allocable to income not included in the measure of tax are disallowed under RTC Section 24425 (thereby preventing a double benefit). In contrast, the industry contends that application of RTC Section 24425 causes double taxation and does not apply.

This bill would specify that Section 24425 does not apply for taxable years ending on or after December 1, 1997, and beginning before January 1, 2003. It would impact two cases currently on appeal at the Board of Equalization; one case with a California-domiciled parent corporation and the other with a parent corporation domiciled in another state.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 263
As Amended June 2, 2003

AMENDMENT 1

On page 5, line 38, strikeout "Paragraph (3)" and insert:

Paragraph (5)

AMENDMENT 2

On page 6, line 33, after "tax" insert:

remitted or

AMENDMENT 3

On page 6, line 38, after "tax" insert:

remitted or

AMENDMENT 4

On page 6, line 39, strikeout "by the Franchise Tax Board" and insert:

pursuant to the election under subdivision (b) of Section 24410 of the Revenue and Taxation Code